Corporate governance in Islamic banks

The Muslim banking world faces the challenge of expanding internationally while remaining true to Islamic principles

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Introduction

Corporate governance in banking has been analysed almost exclusively in the context of conventional banking markets. For example, there has recently been some discussion of the role 'market discipline' exerted by bank shareholders and depositors in constraining the risk taking behaviour of bank management. At the same time, there is growing interest in, and analysis of, banks as stockholders in companies themselves playing a central role in corporate governance, especially in Germany and other countries with universal banking structures of the traditional type.

By contrast, little is written on governance structures in Islamic banking, despite the rapid growth of Islamic banks since the mid 1970s and their increasing presence on world financial markets. There are now over 180 financial institutions world-wide which adhere to Islamic banking and financing principles. These banks operate in 45 countries encompassing most of the Muslim world, along with Europe, North America and various offshore locations. Islamic financing increasingly is a market segment of interest of Western banks, and the latest addition to the list of Islamic banks in October 1996 in the Citi Islamic Investment Bank, Bahrain a wholly owned subsidiary of Citicorp.

Islamic banking represents a radical departure from conventional banking, and from the viewpoint of corporate governance, it embodies a number of interesting features since equity participation, risk and profit-and-loss sharing arrangements from the basis of Islamic financing. Because of the bank on interest (*riba*), an Islamic bank cannot charge any fixed return in advance, but rather participates in the yield resulting from the use of funds. The depositors also share in the profits according to predetermined ratio, and are rewarded with profit returns for assuming risk. Unlike a conventional bank which is basically a borrower and lender of funds, an Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment.

These financial arrangements imply quite different stockholder relationships, and by corollary governance structures, from the conventional model since depositors have a direct financial stake in the bank's investment and equity participations. In addition, the Islamic bank is subject to an additional layer of governance since the suitability of its investment and financing must be in strict conformity with Islamic law and the expectations of the Muslim community. For this purpose, Islamic banks employ an individual *sharia Advisor and/or Board*.

My examination of corporate governance in Islamic banking begins with the comparing governance structures in the Islamic bank and will continues with the principles of Islamic banking. This study compares the Islamic banking, financial model and its implications for governance structures. The study intends to give a small picture on the principles of Islamic banking.

The Islamic bank

Governance structures are quite different from these under Islamic banking because the

institution must obey a different set of rules - those of the *Holy Qur'an* - and meet the expectations of Muslim community by providing Islamically-acceptable financing modes. These profit-and-loss sharing methods, in turn, imply different relationships than under interest-based borrowing and lending.

Figure 1 sets out the key stockholders in an Islamic bank. There are two major difference from the conventional framework. First, and foremost, an Islamic organisation must serve God. It must develop a distinctive corporate culture, the main purpose of which is to create a collective morality and spirituality which, when combined with the production of goods and services, sustains the growth and advancement of the Islamic way of life. To quote janachi (1995):

'Islamic banks have a major responsibility to shoulder ....all the staff of such banks and customers dealing with them must be reformed Islamically and act within the framework of an Islamic formula, so that any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God.' (p.42).

There are equivalent obligations upon employees:

'The staff in an Islamic bank should, throughout their lives, be conducting in the Islamic way, whether at work or at leisure.' (p.28).

Further, obligations also extend to the Islamic community:

'Muslims who truly believe in their religion have a duty to prove, through their efforts in backing and supporting Islamic banks and financial institutions, that the Islamic economic system is an integral part of Islam and is indeed for all times ... through making legitimate and *Halal profits*.' (p.29).

Second, interest-free banking is based on the Islamic legal concepts of *shirkah* (partnership) and *mudaraba* (profit-sharing). An Islamic bank is conceived as financial intermediary mobilising savings from the public on a *mudaraba* basis and advancing capital to entrepreneurs on the same basis. A two-tiered profit-and-loss sharing arrangement operates under the following rules:

a. The bank receives funds from the public on the basis of unrestricted *mudaraba*. There are no restrictions imposed on the bank concerning the kind of activity, duration, and location of the enterprise, but the funds cannot be applied to activities which are forbidden by Islam

b. The bank has the right to aggregate and pool the profit from different investments, and share the net profit (after deducting administrative costs, capital depreciation and Islamic tax) with depositors according to a specified formula. In the event of losses, the depositors lose a proportional share or the entire amount of their funds. The return to the financier has to be strictly maintained as a share of profits.

c. The bank applies the restricted from of *mudaraba* when funds are provided to entrepreneurs. The bank has the right to determine the kind of activities, the duration, and location of the projects and monitor the investments. However, these restrictions may not be formulated in a way which harms the performance of the entrepreneur, and the bank cannot interfere with the management of the investment. Loan covenants and other such constraints usual in conventional commercial bank lending are allowed.

d. The bank cannot require any guarantee such as security and collateral from the entrepreneur in order to insure its capital against the possibility of an eventual loss.

e. The liability of the financier is limited to the capital provided. On the other hand, the liability of the entrepreneur is also restricted, but in this case solely to labour and effort employed. Nevertheless, if negligence or mismanagement can be proven, the entrepreneur may be liable for the financial loss and be obliged to remunerate financier

accordingly.

f. The entrepreneur shares the profit with bank according to previously agreed division. Until the investment yields a profit, the bank is able to pay a salary to the entrepreneur based on the ruling market salary.

Many of the same restrictions apply to *musharaka* financing, except that in this instance the losses are borne proportionately to the capital amounts contributed. Thus under these two Islamic modes of financing, the project is managed by the client and not by the bank, even though the bank shares the risk. Certain major decisions such as changes in the existing lines of business and the disposition of profits may be subject to the bank's consent. The bank, as a partner, has the right to full access to the books and records, and can exercise monitoring and follow-up supervision. Nevertheless, the directors and management of the company retain independence in conducing the affairs of the company.

These conditions give the finance many of the characteristics of non-voting equity capital. From the viewpoint of the entrepreneur, there are no fixed annual payments needed to service the debt as under interest financing, while the financing does not increase the firm's risk in the way that other borrowings do through increased leverage. Conversely, from the bank's viewpoint, the returns come from profits - much like dividends - and the bank cannot take action to foreclose on the debt should profits no eventuate.

Governance structures

These structures are depicted in Figure 2 which sketches the conceptual framework of corporate governance for Islamic bank. Central to such a framework is the *Sharia Supervisory Board* (SSB) and the internal controls which support it. The SSB is vital for two reasons. First, those who deal with an Islamic bank require assurance that it is transacting with Islamic law. Should the SSB report that the management of the bank has violated the *sharia,* it would quickly lose the confidence of the majority of its investors and clients. Second, some Islamic scholars argue that strict adherence to Islamic religious principles will act as a counter to the incentive problems outlined above. The argument is that the Islamic moral code will prevent Muslims from behaving in ways which are ethically unsound, so minimising the transaction costs arising from incentive issues. In effect, Islamic religious ideology acts as its own incentive mechanism to reduce the inefficiency that arises from asymmetric information and moral hazard.

Such matters are obviously basic to the successful operation of Islamic modes of finance, and they are assessed in the next section when I examine Principles of Islamic Banking.

Principles of Islamic banking

An Islamic bank is based on the Islamic *faith* and must stay within the limits of Islamic Law or the *sharia* in all of its actions and deeds. The original meaning of the Arabic word *sharia* was 'the way to the source of life' and it is now used to refer to legal system in keeping with the code of behaviour called for by the *Holly Qur'an* (Koran). Four rules govern investment behaviour:

a. the absence of interest-based *(riba)* transactions;

b. the avoidance of economic activities involving speculation *(ghirar)*;

c. the introduction of an Islamic tax, *zakat*;

d. the discouragement of the production of goods and services which contradict the value pattern of Islamic *(haram)*

In the following part I explain these four elements give Islamic banking its distinctive religious

identity.

Riba

Perhaps the most far reaching of these is the prohibition of interest *(riba)*. The payment of *riba* and the taking as occurs in a conventional banking system is explicitly prohibited by the *Holy Qur'an*, and thus investors must be compensated by other means. Technically, *riba* refers to the addition in the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan. While earlier there was a debate as to whether *riba* relates to interest or usury, there now appears to be consensus of opinion among Islamic scholars that the term extends to all forms of interest.

In banning *riba*, Islamic seeks to establish a society based upon fairness and justice *(Qur'an 2.239)*. A loan provides the lender with a fixed return irrespective of the outcome of the borrower's venture. It is much fairer to have a sharing of the profits and losses. Fairness in this context has two dimensions: the supplier of capital possesses a right to reward, but this reward should be commensurate with the risk and effort involved and thus be governed by the return on the individual project for which funds are supplied.

Hence, what is forbidden in Islamic is a predetermined return. The sharing of profit is legitimate and that practice has provided the foundation for Islamic banking.

Ghirar

Another feature condemned by Islamic is economic transactions involving elements of speculation, *ghirar*. Buying goods or shares at low and selling them for higher price in the future is considered to be illicit. Similarly an immediate sale in order to a void a loss in the future is condemned. The reason is that speculators generate their private gains at the expense of society at large.

Zakat

A mechanism for the redistribution of income and wealth is inherent is Islam, so that every Muslim is guaranteed a fair standard of living, *nisab*. An Islamic tax, *Zakat* (a term derived from the Arabic *zaka*, meaning "pure") is the most important instrument for the redistribution of wealth. This tax is a compulsory levy, one of the five basic tenets of Islam and the generally accepted amount of the *zakat* is one fortieth (2.5 per cent) of Muslim's annual income in cash or kind from all forms of assessed wealth exceeding *nisab*.

Every Islamic bank has to establish a *zakat* fund for collecting the tax and distributing it exclusively to the poor directly or through other religious institutions. This tax is imposed on the initial capital of the bank, on the reserves, and on the profits as described in the Handbook of Islamic Banking.

Haram

A strict code of 'ethical investment' operates. Hence it is forbidden for Islamic banks to finance activities or items forbidden in Islam, *haram*, such as trade of alcoholic beverage and pork meat.

Furthermore, as the fulfilment or materials needs assures a religious freedom for Muslims, Islamic banks are required to give priority to the production of essential goods which satisfy the needs of the majority of the Muslim community, while the production and marketing of luxury activities, *israf wa traf* is considered as unacceptable from a religious viewpoint.

In order to ensure that the practices and activities of Islamic banks do not contradict the Islamic ethical standards, Islamic banks are expected to establish a *Sharia Supervisory Board*, consisting of Muslim jurisprudence, who act as advisers to the banks.

Profit-sharing agreements

Although the restriction against the use of interest might seem to be a binding constraint upon expansion, Islamic banks and financial institutions have in fact grown rapidly. Table 1 sets out the number of banks, paid up capital, total deposits and total assets of these Islamic banks, classified by region. It shows that the total assets of these reporting banks amounted to US $155 billion in 1994, with employment in excess of 220,000 (data supplied by the International Association of Islamic Banks).

If the paying and receiving of interest is prohibited, how do Islamic banks operater It is necessary to distinguish between the expressions 'rate of interest' and 'rate of return'. Whereas Islam clearly forbids the former, it not only permits, but rather encourages, trade. In the interest-free system sought by adherents to Muslim principles, people are able to earn a return on their money only by subjecting themselves to the risk involved in profit sharing. As the use of interest rates in financial transactions is prevented, Islamic banks are expected to undertake operations only on the basis of *Profit and Loss Sharing* (PLS) arrangements or other acceptable modes of financing. *Mudaraba* and *musharaka* are the two profit-sharing arrangements preferred under Islamic law.

Mudaraba

A *mudaraba* can be defined as contract between at least two parties whereby one party, the financier *(sahib al-mal)*, entrusts funds to another party, the entrepreneur *(mudarib)*, to undertake an activity or venture. This type of contract is in contrast with *musharaka*. In arrangements based on *musharaks* there is also profit-sharing, but all parties have the right to participate in managerial decisions. In *mudaraba*, the financier is not allowed a role in management of the enterprise. Consequently, *mudaraba* represents a PLS contract where the return to lenders is a specified share in the profit/loss outcome of the project in which they have a stake, but no voice.

In interest lending, the loan is not contingent on the profit or loss outcome, and is usually secured, so that the debtor has to repay the borrowed capital plus the fixed interest amount regardless of the resulting yield of the capital.

Under *mudaraba*, the yield is not guaranteed in profit-sharing and financial losses are borne completely by the lender. The entrepreneur as such losses only the time and effort invested in the enterprise. This distribution effectively treats human capital with equally financial capital.

Musharaka

Under *musharaka*, the entrepreneur adds some of his own to that supplied by the investors, so exposing himself to the risk of capital loss. Profits and losses are shared according to pre-fixed proportions, but these proportions need not coincide with the ratio of financing input. The bank sometimes participates in the execution of the projects in which it has subscribed, perhaps by providing managerial expertise. Figure 3 illustrates the elements.

Mudaraba and *musharaka* constitute, at least in principle if not always in practice, the twin pillars of Islamic banking.

The two methods conform fully with Islamic principles, in that under both arrangements lenders share in the profits and losses of the enterprises for which funds are provided and *shirkah* (partnership) is involved. The *musharaka* principle in invoked in the equity structure of Islamic banks and is similar to the modern concepts of partnership and joint stock ownership.

Two-tiered mudabara

For banking operations, the *mudaraba* concept has been extended to include three parties: the depositors as financiers, the bank as an intermediary, and the entrepreneur who requires funds.

The bank acts as an entrepreneur when it receives funds from depositors, and as financier when it provides the funds to entrepreneurs. In other words, the bank operates a two-tier *mudaraba* system in which it acts both as the *mudarib* on the saving side of the equation and as the *rubbul-mal* (owner of capital) on the investment portfolio side. Insofar as the depositors are concerned, an Islamic bank acts as a *mudarib* which manages the funds of the depositors to generate profits subject to the rules of *mudaraba*. The bank may in turn use the depositors' funds on a *mudaraba* basis in addition to other lawful (but less preferable) modes of financing, including mark up or deferred sales, lease purchase and beneficence loans. The funding and investment avenues are now listed.

Sources of funds

Besides their own capital and equity, Islamic banks rely on two main sources of funds, a) transaction deposits, which are risk free but yield no return and, b) investment deposits, which carry the risks of capital loss for the promise of variable. In all, there are four main types of accounts:

Current accounts

Current accounts are based on the principle of *al-wadiah,* whereby the depositors are guaranteed repayment of their funds. At the same time, the depositor does not receive remuneration for depositing funds in a current account, because the guaranteed funds will not be used for PLS ventures. Rather, the funds accumulating in these accounts can only be used to balance the liquidity needs of the bank and for short-term transactions on the bank's responsibility.

Savings accounts

Savings accounts also operate under the *al-wadiah* principle. Savings accounts differ from current deposits in that they earn the depositors income: depending upon financial results, the Islamic bank may decide to pay a premium, *hiba,* at its discretion, to the holders of savings accounts.

Investment accounts

An investment account operates under the *mudaraba al-mutlaqa* principle, in which the *mudarib* (active partner) must have absolute freedom in the management of the investment of the subscribed capital. The conditions of this account differ from those of the savings accounts by virtue of: a) a higher fixed minimum amount, b) a longer duration of deposits, and c) most importantly, the depositor may lose some of or all his funds in the event of the bank making losses.

Special investment accounts

Special investment accounts also operate under the *mudaraba* principle, and usually are directed towards larger investors and institutions. The difference between these accounts and the investment account is that the special investment account is related to a specified project, and the investor has the choice to invest directly in a preferred project carried out by the bank.

Uses of funds

The *mudaraba* and *musharaka* modes, referred to earlier, are supposedly the main conduits for the outflow of funds from banks. In practice, however, other important methods applied by Islamic banks include:

Murabaha (mark up). The most commonly used mode of financing seems to be the 'mark-up' device. in a *murabaha* transactions, the bank finances the purchase of a good or assets by buying it on behalf of its client and adding a mark-up before reselling it to the client on a 'cost-

plus' basis profit contract. Figure 4 illustrates the sequence.

Bai' muajjal (deferred payment). Islamic banks have also been resorting to purchase and resale of properties on a deferred payment basis. It is considered lawful in *fiqh* (jurisprudence) to charge a higher price for a good if payments are to be made at a later date. According to *fiqh* this does not amount to charging interest, since it is not a lending transaction but a trading one.

Bai'salam (prepaid purchase). This method is really the opposite of the *murabaha*. There the bank gives the commodity first, and receives the money later. Here the bank pays the money first and receives the commodity later, and is normally used to finance agricultural products.

Istissanaa (manufacturing). This is a contract to acquire goods on behalf of a third party where the price is paid to the manufacturer in advance and the goods produced and delivered at a later date.

Ijara and ijara wa iqtina (leasing). Under this mode, the banks buy the equipment or machinery and lease it out to their clients who may opt to buy the items eventually, in which case the monthly payments will consist of two components, i.e. rental for the use of the equipment and instalment towards the purchases price.

Qard hasan (beneficence loans). This is the zero return type of loan that the *Holly Qura'n* urges Muslims to make available to those who need them. The borrower is obliged to repay only the principal amount of the loan, but is permitted to add a margin at his own discretion.

Islamic securities. Islamic financial institutions often maintain an international Islamic equity portfolio where the underlying assets comprise ordinary shares in well run businesses, the productive activities of which exclude those on the prohibited list (alcohol, pork, armaments) and financial service based on interest income.

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Footnotes

1. This treatise, first published in 1990, is distributed by the Baharain Islamic Bank.
2. The concepts are examined in Siddiqi (1983) and Abdul Gafoor (1995).
3. The incentive problems are examined in Ul-Haque and Mirakhor, (1986).
4. The higher price shows in (HIB, 1982, vol., p.427).
5. The five basic tenets (or pillars) are: (1) acceptance of shahada, (2) prayer or namaz, (3) zakat or alms, (4) fasting, and (5) hajj or pilgrimage to Mecca.
6. The Islam clearly forbids are examined in Khan, 1986, pp. 4-6.